

## IRS Regulations Effective: Tax-Free Reorganizations Can Include Single Member LLCs

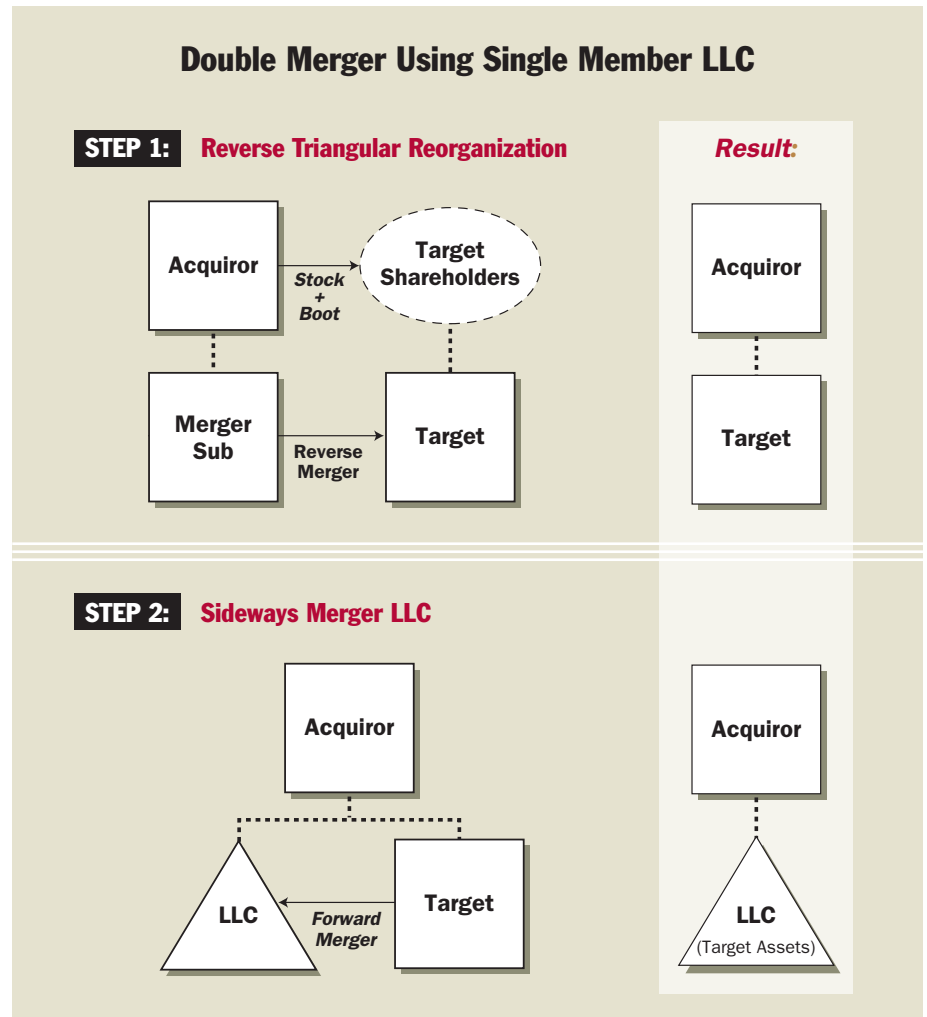
### Overview

Recently released IRS regulations sanction the tax-free merger of a target corporation into an acquiring corporation's wholly-owned limited liability company ("LLC"). These new regulations, coupled with the "double merger" technique discussed in an earlier Cooley Alert, permit a corporate acquirer to accomplish the following:

- isolate the target's pre-existing liabilities while ignoring the target's existence for tax purposes,
- acquire a target corporation in a triangular tax-free reorganization by paying aggregate consideration that includes a stock component representing as little as 50% of the total consideration,
- avoid many of the constraints applicable to traditional triangular reorganizations, such as the requirement that the acquirer purchase and hold substantially all of the target's assets,
- eliminate the corporate level tax exposure in the event the transaction does not qualify as a tax-free reorganization, and
- effect a swift acquisition of the target by deferring required pre-closing third-party consents, thereby avoiding resulting delays often associated with a traditional forward merger.

### Detailed Analysis

On January 23, 2003, the IRS issued temporary regulations permitting the forward merger of a domestic corporation into a disregarded entity wholly-owned by another domestic corporation to qualify as an "A" reorganization under Section 368(a)(1)(A)



of the Internal Revenue Code (the "Code"). In other words, for tax purposes, the merger of a corporation into a disregarded entity will be treated as if the target merged directly into the acquirer. A "disregarded entity" refers to a business entity with only one owner that is disregarded for tax purposes but respected

for other purposes. The most common example of a disregarded entity is a single member LLC that has not elected to be classified as a corporation for tax purposes.

The classification of a corporation's merger into a single member LLC as an "A"

reorganization makes it an attractive acquisition structure for several reasons, discussed below.

### Limited Liability

Upon a true direct or “forward” merger of a target into an acquiror, the target disappears and the acquiror inherits the target’s liabilities by operation of law. Upon the merger of a target into a single member LLC owned by the corporate acquiror, on the other hand, the LLC rather than the corporate acquiror inherits the target’s liabilities. The reason: while a single member LLC is disregarded for tax purposes, it remains separate and distinct from its owner for other purposes, including that of limiting its owner’s liability for the LLC’s obligations. Thus, a corporate acquiror that merges a target into the acquiror’s wholly-owned LLC can successfully isolate the target’s pre-existing liabilities.

### Substantial Cash Consideration

The Internal Revenue Code permits varying amounts of cash consideration in a tax-free reorganization depending upon the form of the transaction. In a tax-free reverse triangular merger under Section 368(a)(2)(E) of the Code, for example, at least 80% of the target corporation’s stock must be acquired solely for acquiror voting stock, thereby limiting the use of nonvoting stock and “boot” (non-qualifying merger consideration such as cash or warrants) in the transaction. Alternatively, an “A” reorganization under Code Section 368(a)(1)(A) requires only that the stock consideration be adequate to satisfy the historical “continuity of interest” requirement. The Service’s advance ruling guidelines require at least 50% stock consideration to satisfy this requirement. However, case law permits a somewhat higher percentage of cash.

The new regulations classify the merger of a corporate target into the wholly-owned LLC of a corporate acquiror as an “A” reorganization. As a result, even if 50% (or more) of the aggregate consideration paid in the merger consists of cash, the stock issued in the transaction may still be received tax-free.

### Fewer Technical Constraints

Traditional forward triangular mergers, which require use of a corporate acquisition subsidiary, are only eligible for tax-free treatment under Code Section 368(a)(2)(D). Forward triangular mergers involving disregarded entities, on the other hand, are treated the same as direct mergers and thus are governed by the much less restrictive requirements of Code Section 368(a)(1)(A). Section 368(a)(2)(D) requires, for example, that the acquiror obtain substantially all of the target’s assets, which limits the target’s ability to engage in certain transactions, including distributions, redemptions or spin-offs made in connection with (or close in time to) the acquisition. Additionally, Section 368(a)(2)(D) can prove problematic if either a target stockholder or the acquiror has made a bridge loan to the target prior to the transaction. An “A” reorganization involving a disregarded entity is not encumbered by either of these issues.

### Combination with Reverse Triangular Merger Reduces Tax Exposure and Minimizes Delays

The new regulations, when read in conjunction with the IRS’s ruling regarding double mergers (see previous Cooley Alert: [http://www.cooley.com/publications\\_content.ix?section=Cooley+Alerts+%26+Bulletins&id=2783](http://www.cooley.com/publications_content.ix?section=Cooley+Alerts+%26+Bulletins&id=2783)) suggest that if the merger of a target into a single member LLC owned by the acquiring corporation is preceded by a reverse triangular merger of the target with a corporate subsidiary also owned by the corporate acquiror, the acquiror will have the ability not only to simultaneously achieve the objectives noted above, but also to eliminate the corporate level tax exposure in the event the transaction does not qualify as a tax-free reorganization, and effect a swift acquisition of the target by deferring any required third-party consents, thereby avoiding resulting delays often associated with a traditional forward merger.<sup>1</sup>

### Reduced Tax Exposure

Forward mergers, whether direct or triangular, are subject to two levels of tax if they

are subsequently found to be taxable. In addition to a stockholder level tax, there is a tax at the corporate level, because the target corporation is deemed to have sold all of its assets, generally at their fair market value. As a practical matter, because the acquiror is the successor to the target, this corporate tax becomes the acquiror’s tax liability.

By contrast, a taxable reverse triangular merger triggers only a single level of tax, paid at the stockholder level. This unique advantage of reverse triangular mergers (no corporate level tax) should be effectively available to a forward merger involving a disregarded entity, if such merger is immediately preceded by a reverse triangular merger. In other words, if the target corporation merges first with the acquiror’s transitory corporate subsidiary (with the target surviving), and then merges with the acquiror’s single member LLC (with the LLC surviving), any corporate level tax exposure should be eliminated in the event the IRS successfully challenges the transaction’s status as a tax-free reorganization. Why? If the transactions do not qualify, in the aggregate, as an “A” reorganization, they will be respected in their component parts: namely, a taxable reverse triangular merger followed by a tax-free merger of the target into the acquiror’s LLC.

### Minimal Delays

Often, a forward merger involves additional consents not necessary in a reverse triangular merger (e.g., consent by various vendors to the assignment to the surviving entity of any outstanding contracts). Since the target survives in a reverse triangular merger, this structure avoids the necessity of obtaining many of these consents, thereby allowing the parties to close more quickly. A double merger structure involving a disregarded entity allows the parties to achieve a quick close (since the reverse triangular merger occurs first) and subsequently go about obtaining any necessary consents prior to the second step (the disregarded entity merger).

In light of these new rulings and regulations, we believe corporations should

systematically consider utilizing disregarded entities as a tax-planning tool.

Should you have any questions, please contact any of the attorneys listed below. ■

### Notes

<sup>1</sup> If there is significant risk that third party consents may never be forthcoming, the parties may be limited to a traditional reverse triangular merger structure. Interestingly, if such contracts were entered into by target's wholly owned LLC (rather than by target, directly) third party consents might be avoided entirely, in the absence of a change-in-control consent provision.

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